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SUBJECT: THE CENTRAL BANK: THE BRV'S ELEPHANT BRIGADE

This message is Sensitive But Unclassified, please treat accordingly.

¶1. (SBU) SUMMARY: Central Bank (BCV) Director Domingo Felipe Maza Zavala told Econoffs February 15 that the BCV's primary role these days is to mitigate/accommodate the monetary affects of the BRV's "enormous" fiscal expenditures. The always understated and professorial Maza maintained that the BCV was an autonomous public institution with a constitutional mandate to support state goals; noted that, with the passage of the July 2005 Central Bank Law, the BCV no longer had the exclusive rights to the country's petroleum-driven foreign exchange earnings; and asserted that the accumulated foreign exchange holdings of various BRV institutions exceeded those of the BCV (currently USD 28.79 billion). He also added that the BCV continues its efforts to manage the country's growing money supply, which are hindered by exchange controls, election year spending, debt accumulation, and interest rate controls. END SUMMARY.

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BCV ROLE: MITIGATING AFFECTS OF BRV FISCAL POLICY
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¶2. (SBU) According to Maza, the Central Bank (BCV) derives its autonomy from the 1999 BRV Constitution, but, must also cooperate with the BRV to promote economic stability, economic growth and economic welfare. He noted that the BCV and the Executive Branch have an annual requirement, established by constitution and law, to set goals for economic growth, inflation, the current account, and the maximum fiscal deficit each year. This year will mark the first time this agreement will be formalized, which was not possible in prior years because of "political turmoil" (read: strike, referendum, etc). Each BRV entity must, in turn, work to support these goals.

¶3. (SBU) Maza, in a non-critical tone, said the BRV determined fiscal policy, and the BCV has tried to mitigate the monetary effect of BRV expenditures, which would be "enormous" in 2006 (Note: In 2006, BRV expenditures will be at least 30.5 percent of GDP, with additional significant off-budget expenditures in the neighborhood of an additional 10 percent of GDP expected. End Note.) Maza added that the issuance of domestic bonds (new domestic debt) helped the banking sector, which lacked options to place money to complement their other portfolio investments. The BRV also

benefited, by using debt to pay for its needs. Maza described the Venezuelan debt-to-gdp profile (currently 37.8 percent) as more manageable than Brazil's, Argentina's, and Mexico's. Despite Venezuela's ability to assume more debt, Maza said that it did not have the need and a good option would be to pay down some of the foreign debt with current petroleum income. (Comment: Maza's caution and professorial nature often make him a master of the obvious. End Comment.)

THE CENTRAL BANK REFORM

¶4. (SBU) In the past, the BCV exclusively managed the foreign exchange earnings of Petroleos de Venezuela (PDVSA). Under the 2005 Central Bank law, the BCV was required to make a one-time transfer to the National Development Fund (FONDEN) of USD 6 billion. Under the new law, Maza said, PDVSA negotiates the amounts needed to meet Venezuela's currency needs with the BCV, maintains foreign currency for its needs abroad, and transfers the rest to FONDEN (for 2006 PDVSA plans to transfer around USD 100 million a week to the fund according to public statements by Chavez and other senior BRV officials. FONDEN currently has around USD 8 billion available to spend).

¶5. (SBU) Maza said he originally opposed the transfer of Central Bank reserves to FONDEN, but added that FONDEN may actually help alleviate the excess liquidity problem as foreign exchange earnings that go directly from PDVSA to FONDEN do not enter the monetary base (i.e., are not transferred into Bolivars). FONDEN would only make requests of the Central Bank when it needed Bolivars, Maza said. (Note: FONDEN resources were originally intended to be spent for imports or to pay foreign debt. End Note.) He added that, in addition to FONDEN, other public entities, such as the Fund to Guarantee the Deposits of Financial Institutions (FOGADE), the Economic and Social Development Bank (BANDES), the Ministry of Finance, and PDVSA also hold foreign exchange, in amounts that exceed the gross international reserves of the BCV (Currently, USD 28.79 billion). However, he distinguished these foreign exchange holdings from &reserves8, because they are not under BCV control and they do not have the function of reserves.

¶6. (SBU) The Central Bank Law (July 2005) also established the concept of "adequate level of reserves.8 Maza noted that the Central Bank must determine how much is needed to meet Venezuela's external obligations and pay for international transactions. Maza said that the figure was confidential for strategic reasons. (Comment: We anticipate

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that the adequate reserve level will be around USD 25 billion, as Chavez has announced in the past. In February 2005, Chavez proposed the BCV transfer another USD 4 billion to FONDEN. End Comment.) Eventually the BCV will need to transfer to FONDEN the excess reserves, but current law does not provide a mechanism to do so, said Maza.

MONETARY LIQUIDITY

¶7. (SBU) Monetary liquidity is very high (M2 grew around 53 pct growth year on year) and will continue to grow, Maza said, due primarily to the strong inflow of petrodollars, fiscal spending levels, and exchange controls. In an effort to mop up liquidity, the BCV has issued the Bolivar equivalent of around USD 14 billion in CDs, which is costly (around USD 871 million in 2005). To lower costs, the BCV earlier this month lowered CD interest rates and eliminated the 56-day CDs, now offering just 14 and 28 day issuances. Maza said that BANDES, PDVSA, and FONDEN investments abroad help contain some of the liquidity growth.

¶8. (SBU) With exchange controls in place and BRV legislative

branch and executive mandates setting certain interest rates, Maza said that the BCV does not have many options to control liquidity. Exchange controls were established in February 2003, following the coup, the strike, and the fall of petroleum prices, all of which exacerbated to capital flight according to Maza. He described that traditionally the Venezuelan balance of payments' current account has been strong while the capital account traditionally has been weak and negative because of capital flight. Under the current regime, the legal forms of exchange include requesting dollars through the Foreign Exchange Control Commission (CADIVI), or purchasing BRV dollar denominated bonds or CANTV ADRs, which can be purchased locally for Bolivars and then sold abroad for dollars. Maza noted that the parallel market is another option for exchange, though not legal, and that the official rate and parallel rate differ.

COMMENT

¶9. (SBU) The 83-year old Maza has publicly called for regulations for the management of FONDEN and publicly defended the BCV's independence. He has been an academic for most of his career, a former deputy in the legislature, and an author of economic textbooks that are widely used throughout Venezuela. While choosing his words carefully, he has demonstrated, through public statements and press interviews, a greater willingness to be open about his opinions (which in economic terms are seemingly orthodox), particularly when they relate to defending perceived BCV prerogatives. While hewing close to the official line, Maza's comments underscored the challenges BRV fiscal policy and quasi-monetary policy (selective interest rate controls) have for the country's principal monetary authority.
WHITAKER